

U S WEST, INC.'S RESPONSE TO DRAFT AUDIT FINDINGS
AUDIT OF CONTINUING PROPERTY RECORDS

EXECUTIVE SUMMARY

In this response, U S WEST addresses the substantive issues raised by the Commission's Accounting Safeguards Division ("ASD") in its draft report, dated December 22, 1998, on its audit of continuing property records ("CPR") for hard-wired central office equipment. ASD's findings in its December report are virtually unchanged from its July draft. This is extremely disappointing to U S WEST – not only because ASD failed to reflect any data contained in U S WEST's August 19, 1998 submittal but because U S WEST personnel spent thousands of hours examining archived records, some of which were decades old, in a futile attempt to correct deficiencies in ASD's draft audit. Furthermore, it is contrary to generally accepted government auditing standards ("GAGAS") and raises serious questions with respect to the purpose of the audit.

U S WEST has found nothing in ASD's December audit report that would cause it to revise its conclusions that the audit is fatally flawed and provides no basis for drawing any valid conclusions with respect to U S WEST's COE hard-wired investment. Among other things the audit report provides no explanation as to:

why ASD failed to follow-up on U S WEST's documentation indicating that the majority of ASD's audit findings were resolved

why ASD proposes a significant write-down when U S WEST provided ASD with data indicating that a majority of the equipment was found

why ASD proposes writing-off Undetailed Investment when U S WEST has provided a full explanation of the amounts in this category

why ASD declines to follow generally accepted government auditing standards

why ASD excluded 500 U S WEST offices in selecting its audit sample

the rationale for using a large number of strata with relatively few central office selections per strata

why the “random” selection process was based on units without consideration of the dollar-value of CPR items

how ASD’s “estimates” can be of any predictive value given that the range of uncertainty is very large (\$394.8 million)

why ASD did not consider “understatement” errors as well as errors of “overstatement”

While each of the above items by itself may be explainable, as a whole, it is impossible to adequately explain away all the statistical and non-statistical issues associated with ASD’s audit.

At an absolute minimum, the Commission should direct ASD to revise its audit report to reflect the additional items identified as found in U S WEST’s August 19, 1998 submission. Furthermore, the Commission should abstain from drawing any conclusions with respect to U S WEST’s COE hard-wired investment, as a whole, until ASD provides answers some basic questions associated with how it selected the sample used in the U S WEST field audit and ASD validates its sampling methodology.

U S WEST acknowledges that its CPR records are not error-free. This would be unheard of given the detailed nature of the Commission’s Part 32 rules which require CPR cost support data to be maintained for the life of the equipment regardless of the value of the investment. U S WEST also acknowledges that its

internal processes for maintaining CPR records could be improved and that it is taking steps to correct any deficiencies in its processes. U S WEST is willing to work with the Commission to address concerns that the Commission might have with respect to U S WEST's records. However, U S WEST would be remiss if it did not express both its concern and dissatisfaction with ASD's December audit report. This report neither recognizes the extraordinarily detailed and burdensome nature of the Commission's CPR recordkeeping rules, nor U S WEST's efforts to comply with these rules and correct inaccuracies in ASD's field audit.

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In this response, U S WEST, Inc. (“U S WEST”) addresses the substantive issues raised by the Federal Communications Commission’s Accounting Safeguards Division (“ASD”) in its draft report, dated December 22, 1998, on its audit of continuing property records (“CPR”) for hard-wired central office equipment (“COE”) and “undetailed” investments and “unallocated” other costs.¹ This response incorporates much of the same material that U S WEST submitted to ASD on August 19, 1998² in responding to ASD’s earlier draft audit report provided on July 20, 1998.³

I. **INTRODUCTION**

ASD’s findings in its December report are virtually unchanged from its July draft report. This is extremely disappointing to U S WEST – not only because ASD failed to reflect any data contained in U S WEST’s August 19, 1998 submittal but because U S WEST personnel spent thousands of hours examining archived records, some of which were decades old, in a futile attempt to correct deficiencies in ASD’s draft audit.⁴ Not only did U S WEST submit detailed information on items that

¹ See attachment to letter from A. Mulitz, FCC to K. Abernathy, U S WEST, Inc., dated Dec. 23, 1998.

² See letter from K. Abernathy, U S WEST, Inc. to K. Ackerman, FCC, dated Aug. 19, 1998.

³ See attachment (referred to herein as “July Report”) to letter from H. Boyle, FCC to K. Abernathy, U S WEST, Inc., dated July 20, 1998.

⁴ During the April-August 1998 timeframe alone, U S WEST spent over \$600,000 examining the contents of the approximately 12,000 boxes of COE records in its archives in order to respond to audit inquiries and ASD’s draft audit report.

ASD classified as “not found” or “partially found” in its field audit, U S WEST also engaged an outside statistical expert, Deloitte & Touche, LLP, to examine the sampling methodology used in ASD’s audit and provided this analysis to ASD.

None of this information is reflected in ASD’s December audit report. It appears that ASD did not even consider U S WEST’s submission in finalizing its audit report. This is contrary to both Generally Accepted Auditing Standards (or “GAAS”) and Generally Accepted Government Auditing Standards (or “GAGAS”) and should not be countenanced by the Commission.⁵

At an absolute minimum, the Commission should direct ASD to revise its audit report to reflect the additional items identified as found in U S WEST’s August 19, 1998 submission. Furthermore, the Commission should abstain from drawing any conclusions with respect to U S WEST’s COE hard-wired investment, as a whole, until ASD provides answers to some basic questions associated with how it selected the sample used in the U S WEST field audit and ASD validates its sampling methodology.⁶

It is unconscionable for ASD to recommend that U S WEST “write-down” its COE investment by almost \$600 million when it has failed to consider detailed U S WEST input on sample items and it continues to rely on a highly questionable,

⁵ See Attachment 1 hereto, Declaration of Carl R. Geppert of Arthur Andersen, LLP at 4-5 (“Geppert Declaration”).

⁶ The table of observations in Attachment 2 hereto, letter, dated Jan. 8, 1999, from Ann Thornton, National Director - Data Quality and Integrity Service Line, Deloitte & Touche, LLP (“Jan. 8, 1999 Thornton Letter”), confirms the fact that ASD has neither acknowledged nor responded to virtually any of the numerous concerns that

if not fatally flawed sampling methodology. The Commission should also acknowledge that even if U S WEST's accounting records overstated its COE investment somewhat, there would be no impact on consumer rates due to the fact that Commission rules require telephone companies such as U S WEST to use mass asset accounting and remaining life depreciation.⁷

U S WEST acknowledges that its CPR records are not error-free. This would be unheard of given the detailed nature of the Commission's Part 32 rules, which require CPR cost support data to be maintained for the life of the equipment regardless of the value of the investment.⁸ U S WEST also acknowledges that its internal processes for maintaining CPR records could be improved and that it is taking steps to correct any deficiencies in its processes. U S WEST is also willing to work with the Commission to address concerns that the Commission might have with respect to U S WEST's records. However, U S WEST would be remiss if it did not express both its concern and dissatisfaction with ASD's December audit report. This report neither recognizes the extraordinarily detailed and burdensome nature of the Commission's CPR recordkeeping rules nor U S WEST's efforts to comply with these rules and correct inaccuracies in ASD's field audit.

U S WEST raised in its August 19, 1998 submission with regard to ASD's statistical sampling methodology.

⁷ See Geppert Declaration at 8-9.

⁸ This means that in a perfect world U S WEST would have in its archives the original invoice for an item of COE investment with a value of \$5.00 that was purchased twenty years ago. Clearly, no unregulated business would maintain such records on inconsequential items – the costs would far outweigh any potential benefits.

In the sections that follow U S WEST has attempted to organize its comments in the same manner as the December draft audit report. Much of this material is identical to the information contained in U S WEST's August 19, 1998 response since ASD's December report is so little changed from its July draft.

II. THE COMMISSION MUST BE MINDFUL OF THE METICULOUS NATURE OF ITS PART 32 RULES IN EVALUATING CPR AUDIT RESULTS

The Part 32 rules which establish accounting and recordkeeping requirements for hard-wired COE investment are significantly more detailed than that required to satisfy Generally Accepted Accounting Principles ("GAAP") or other Commission rules pertaining to the treatment of telecommunications plant (*e.g.*, expensing general support assets). As Arthur Andersen, LLP (or "Arthur Andersen") noted in its July 15, 1998 letter addressing Accounting Simplification:

The level of detail at which accounts, subaccounts and detailed plant record categories are defined far exceed the recordkeeping necessary to verify the existence of plant assets and support the asset balances presented in the financial statements.⁹

The true nature of the burden associated with current CPR recordkeeping requirements does not become clear until it is spelled out in more detail:

The CPRs must be established and maintained in subaccounts for each accounting area. Within each accounting area, each property record unit must be listed separately with its original cost, description, location, date of placement and details of construction. This detail is required so as to provide for information necessary to remove original cost upon the retirement of a property unit. All changes to the CPR (other

⁹ Letter from C. Geppert, Arthur Andersen, LLP to M. Salas, FCC, dated July 15, 1998, with attached "Accounting Simplification in the Telecommunications Industry" at 25.

than changes due to telecommunications plant addition and retirement activity) must be submitted to the FCC. A complete description of each property record unit must include the identification of the construction work order, year of installation, specific location within each accounting area to ensure proof of physical existence and the property record unit's identification number. The CPR must disclose the age of existing property, and supplemental records to the CPR must disclose the service life of property retired. In addition, the source of all entries into the CPR must be referenced which supports the quantities and costs recorded in the CPR.¹⁰

The net result of these requirements is that U S WEST has to maintain CPRs on hundreds of thousands of items (*i.e.*, over 500,000 items) related to hard-wired COE investment regardless of value. This excessive level of detail not only increases the cost and burden of recordkeeping but inevitably results in a greater likelihood of errors than would be the case if local exchange carriers ("LECs") were able to track assets at a more reasonable level of detail.

The excessive level of detail required by the Commission's rules also could have a significant impact on audit results if audits are not designed to reflect the wide variation in the dollar-value of COE investment items. The fact that ASD failed to take into account the value of COE line items when selecting the sample for its CPR audit should immediately raise questions with respect to the validity of ASD's findings.¹¹ It should be noted that of the 1,188 items in 33 U S WEST Central

¹⁰ Id. at 28.

¹¹ "Random selection was used [by the ASD] to select line items in each selected office. Typically, when sampling from accounting populations, consideration is given to using dollar-based selection techniques, rather than simple random selections, to allow appropriate coverage of higher dollar items. This is particularly relevant in tests of physical existence if high-dollar items are more likely to be

Offices that ASD selected for its field audit – 449 items or 38% had an original cost of less than \$2000 per item.¹² These 449 items only represented 3% of the total value of all 1,188 items in ASD’s sample.¹³ If anything ASD’s audit demonstrates both the unreasonableness of the Commission’s existing Part 32 recordkeeping requirements for CPRs and the futility of attempting to use a sample so heavily-weighted with low value items to draw conclusions with regard to U S WEST’s overall hard-wired COE investment.

III. ASD’s AUDIT NEITHER COMPLIES WITH GENERALLY ACCEPTED AUDITING STANDARDS (“GAAS”) NOR GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (“GAGAS”)

In preparing its December audit report, ASD all but ignored U S WEST’s August 19, 1998 submission in response to ASD’s July draft report. Clearly, this is contrary to both GAAS and GAGAS.¹⁴ As Mr. Geppert of Arthur Andersen, LLP notes in his attached Declaration, “[m]any government agencies, including the U. S. General Accounting Office (“GAO”), follow generally accepted auditing standards (“GAGAS”) in conducting their audits. These rules codified in Government Auditing Standards, [footnote omitted] specify that ‘auditors should report the views of responsible officials ...concerning auditors’ findings, conclusions and

located than small-dollar items, due to such factors as physical size and the extent of controls over more valuable assets.” See letter from A. Thornton, Deloitte & Touche, L.L.P. to K. Ringsdorf, U S WEST, Inc., dated Aug. 18, 1998 at 2-3 (“Aug. 18, 1998 Thornton Letter”).

¹² This number excludes the 14 items that had an in-place cost of zero. See Geppert Declaration at 10.

¹³ Id.

¹⁴ Id. at 4-5.

recommendations.’ [footnote omitted]”¹⁵ Mr. Geppert also states that “[], these rules require the auditor to evaluate management’s comments on the audit findings and **modify the findings if necessary.**”¹⁶ There is little if any indication that ASD evaluated U S WEST’s submission on ASD’s July draft report.¹⁷

As Mr. Geppert points out:

To perform an effective audit, preliminary audit results should be discussed with management in order to ensure that the auditor has obtained the best evidence possible and reached appropriate conclusions. AA’s firmwide auditing policies require the audit team to discuss preliminary findings with management and, if management presents evidence that contradicts the audit findings and can be verified, the audit team should modify the results to reflect the newly received evidence.¹⁸

ASD has made no attempt to verify any of the detailed information that U S WEST submitted on all sample items that ASD identified as “not found.” This fact alone should cause the Commission to give pause before adopting any of ASD’s audit findings recommendations.

In order to obtain a “reasonableness check” U S WEST asked Arthur Andersen to review U S WEST’s response to ASD’s July draft and ASD’s December draft. Arthur Andersen found ASD’s failure to verify U S WEST’s supplemental

¹⁵ Id.

¹⁶ Id.

¹⁷ The lone statement by ASD that “[a]fter reviewing U S WEST’s responses, we made appropriate adjustments as warranted” hardly provides a basis for claiming that ASD has “evaluated” U S WEST’s response or complied with GAGAS. See December Audit Report at 2.

¹⁸ Geppert Declaration at 4.

evidence to be a major shortcoming of ASD's December Report.¹⁹ Mr. Geppert states that:

AA reviewed the supporting documentation related to the verification efforts performed by USW. In addition, AA selected one of the central offices included in the ASD's sample to perform physical verification procedures to corroborate USW's verification efforts as discussed above. AA was able to physically identify certain assets noted as "found" in USW's response. The evidence submitted by USW suggests that the ASD should have taken additional steps to verify the information and update the audit findings.

The December Report has identical findings to those in the July Report, thus indicating that no consideration was given to the supplemental evidence provided by USW. In addition, per discussion with USW personnel, the ASD did not perform any follow-up procedures to verify the evidence provided by USW.²⁰

In addition to ASD's failure to verify U S WEST's supplemental evidence, Mr. Geppert found several other deficiencies with ASD's physical verification audit procedures including the following:

- No adjustment for timing differences between the date of CPR records used for the audit (*i.e.*, June 30, 1997) and when physical verification actually occurred (*i.e.*, August - September 1997).²¹ Mr. Geppert also cautions that "[p]hysical plant verification procedures must be executed

¹⁹ Id. at 5-6.

²⁰ Id. at 6.

²¹ Id. at 5.

carefully, however, due to the high volume of plant transactions processed in the accounting records at a company the size of USW.”²²

- No consideration of understatement in plant accounting records -- ASD only considered overstatement. “Only by testing for both potential over - and understatements can one begin to form the basis for concluding as to the propriety of the telecommunications plant account balances.”²³
- Restrictive field audit procedures including limited on-site visits (*i.e.*, one day per CO) and no follow-up visits.²⁴
- Failure to review accounting records in addition to CPRs. “To the extent that adjustments had been made to the accounting records and not the supporting CPR detail ...the audit would not have detected such adjustments which obviously would impact any conclusion with respect to the fair presentation of the accounting records.”²⁵

Clearly, the shortcomings pointed out by Mr. Geppert demonstrate that ASD has failed to conduct its audit of U S WEST’s CPR’s in accordance with generally accepted government auditing standards.

²² Id.

²³ Id. at 6.

²⁴ Id. In commenting on the limited amount of time at each location, Mr. Geppert observes that “[t]his limited window of time seems inadequate, particularly considering the fact that certain items of COE tend to be small and ‘built-in’ to other assets, thus making these assets difficult to find.” Id.

²⁵ Id. at 7.

IV. ASD'S REFERENCES TO ITS 1994 AUDIT SERVES NO PURPOSE OTHER THAN TO CAST U S WEST IN AN UNFAVORABLE LIGHT

U S WEST will not address the particulars of the references to the 1994 CPR audit contained in the draft audit report. The findings of the 1994 audit have not been shared previously with U S WEST. The only purpose for including references to the 1994 audit appears to be to cast U S WEST in an unfavorable light. It is interesting to note that ASD removed from the December Report its earlier reference to the fact that the results of the 1994 audit have never been conveyed in writing to U S WEST²⁶ and the fact that there have been no other “formal” communication of the 1994 audit findings to U S WEST. The statement that “[t]he audit staff discussed these concerns with US West representatives during the course of the audit” appears to imply that U S WEST management was made aware of the audit findings and did nothing.²⁷ This is not true. Neither U S WEST representatives in its Washington, D.C. office, nor U S WEST management were made aware of the outcome of the 1994 audit.

Furthermore, references to the overall findings of the 1994 audit are misleading at best. The fact that 16 percent of a non-random sample of 69 items in nine central offices in Omaha, Nebraska could not be found implies nothing about

²⁶ July Report at 4.

²⁷ Draft Audit Report at 5. It should be noted that in its July Report, ASD referred to these discussions as “informal” and refers to U S WEST “employees”, not representatives. These are not trivial distinctions. July Report at 4.

the accuracy of U S WEST's records or the whereabouts of its COE in U S WEST's 14-state operating area.²⁸

No purpose is served by including references to the 1994 audit findings in ASD's draft audit report -- the results are not comparable and may mislead readers as to the significance of the 1994 findings. It does not appear that the 1994 audit was conducted in accordance with generally accepted government auditing standards, including providing U S WEST with an opportunity to comment on preliminary findings.²⁹ The Commission should not allow ASD to taint the 1997 CPR audit with references to an unfinished five-year old audit of such limited scope. As such, U S WEST requests that all references to the 1994 audit be stricken from any final audit report on the 1997 CPR audit.

V. U S WEST HAS ACCOUNTED FOR THE VAST MAJORITY OF THE ITEMS WHICH ASD CLASSIFIED AS "NOT FOUND"

The draft audit report notes that ASD's staff selected a sample of 1,188 records -- consisting of 36 items in 33 central office locations. Of these records, the auditors found 894 or 75.3 percent of the items as specified in the CPR. The auditors encountered problems with 294 items, or 24.7 percent of the sampled records. The results of ASD's field audit are contained on the left-hand side of the following table. As mentioned above, these results are unchanged from ASD's July

²⁸ As we demonstrate herein, many of the items which Commission auditors classified as "not found" in the current audit are actually located in their respective central offices.

²⁹ See Letter to Ms. Kathryn C. Brown, Chief, Common Carrier Bureau from Kathleen Q. Abernathy, U S WEST, Inc. dated July 2, 1998 at Arthur Andersen attachment (Letter to Ms. Kristine M. Ringsdorf, U S WEST, from Carl R. Geppert).

draft report. The right-hand side of the same table reflects the results of U S WEST's subsequent CPR investigation efforts.

FCC Staff Findings					U S WEST Findings			
Category	No. of Line Items	% of Total Line Items	Value	% of Total Value	No. of Line Items	% of Total Line Items	Value	% of Total Value
Assets Found	894	75.3%	\$9,868,692	72.6%	1,134	95.5%	\$13,311,174	97.9%
Assets Partially Found:	19	1.6%		1.5%	6	0.5%		0.8%
Value of found			\$198,127				\$99,924	
Value of missing			\$ 49,469				\$14,591	
No Assets Found	123	10.3%	\$1,157,825	8.5%	48	4.0%	\$168,598	1.3%
Unverifiable Assets	152	12.8%	\$2,320,174	17%	-	-	-	-
Total	1,188	100%	\$13,594,287	100%	1,188	100%	\$13,594,287	100%

The differences are dramatic.³⁰ U S WEST's investigation has verified the existence of approximately 96 percent of the items in the audit sample. As the above table illustrates, U S WEST was unable to locate 4.0 percent -- or 48 -- of the items representing about 1.3 percent of the total value of the audit sample. U S WEST classified these 48 items as "not found" after an extensive examination that focused on whether the items which the auditors identified as "not found" currently were in service or had previously been in service.

One of the first steps, in U S WEST's investigation was to go back to each of the central offices in which sample items were supposed to be located. This effort

³⁰ While the differences between the audit's findings and U S WEST's findings are quite significant, this is hardly surprising given the fact that "documentation provided after the date of the letter [January 27, 1998] could not be incorporated into the audit report." July Report at 7 n.25. ASD also declined to incorporate any additional information in its December report. Of the 142 items that the auditors classified as "not found" or "partially found" and used to derive their estimate of the overstatement of hard-wired COE equipment, U S WEST either located or confirmed that 103 of these items had existed previously.

turned-up items which were located in the appropriately designated COs but the CPR was in error (*e.g.*, incorrect frame identification, erroneous item description, etc.). One of the next steps was to conduct a search of supplemental records to determine whether there was any evidence that the remaining items of COE had been retired -- this accounted for another 22 items on the auditors' "not found" list. Ultimately, U S WEST was able to account for all but 48 of the 1,188 sample items.³¹

Rather than simply identify an item as found, U S WEST disaggregated these items into a number of sub-categories to assist ASD in its analysis. A detailed listing of all 215 items (not including category 2 items) that the auditors identified as "not found" or "unverifiable" was included along with the results of U S WEST's investigative efforts. In those cases where U S WEST identified items as "found," further supporting documentation was provided to demonstrate the existence of the equipment reflected in the CPR.

In summary, U S WEST believes that it has accounted for the vast majority of the items contained in the ASD's audit sample. After further examination, U S WEST has retired/"written-off" most of the remaining items that could not be found in accordance with GAAP. The preceding table also demonstrates that the missing items account for a disproportionately small percentage -- 1.3 percent -- of the value of hard-wired COE plant.³²

³¹ Due to the page limitation placed on this response, U S WEST incorporates by reference the detailed attachments that were included in its August 19, 1998 submission.

³² This fact, in itself, calls into question both the Commission's sampling procedures and its ability to make inferences about U S WEST's investment in hard-wired

VI. ASD's SAMPLING METHODOLOGY IS HIGHLY SUSPECT, IF NOT FATALY FLAWED

U S WEST strongly doubts that the audit results, even if corrected, are representative of its hard-wired COE investment contained in approximately 500,000 records. In order to obtain an objective unbiased assessment of the sampling methodology used in the audit, U S WEST engaged Ann Thornton of Deloitte & Touche, LLP in August, 1998. Ms. Thornton is Deloitte & Touche's "quantitative techniques" expert and is well-known in the field of statistical audit procedures. Ms. Thornton's review of the audit's statistical methodology was contained in Attachment 1, Tab H of U S WEST's August 19, 1998 submission (and is also attached hereto). U S WEST also asked Ms. Thornton to review ASD's December report and to comment on any changes from the July draft report.³³

Ms. Thornton's letter of January 8, 1999 indicates ASD failed to either acknowledge or respond to the vast majority of issues which she raised in her August 18, 1998 letter with regard to ASD's sampling methodology. This is quite perplexing given that it is impossible to evaluate the validity of ASD's sampling techniques without addressing the fundamental issues raised in Ms. Thornton's letter. One can only surmise that the answers to these basic questions would not have reflected kindly upon ASD's sample selection procedures.

COE. As noted in the attached review of the Commission's sampling methodology by Ann Thornton of Deloitte & Touche, the fact that the "random" audit sample was not adjusted to allow appropriate coverage of higher dollar items "is particularly relevant in tests of physical existence if high-dollar items are more likely to be located than small-dollar items." Aug. 18, 1998 Thornton Letter at 3.

³³ See Jan. 8, 1999 Thornton Letter, attached hereto.

Ms. Thornton reiterates the concerns raised in her earlier review of ASD's July draft report. She states that -- due to a lack of information -- she is unable to determine whether or not the statistical estimates contained in the draft report are statistically valid or not. Despite this, Ms. Thornton raises such a broad array of questions associated with both sample selection and sample evaluation, U S WEST can only conclude that it is highly unlikely that the audit's sample results are representative of the overall population (*i.e.*, total hard-wired COE investment). For example, Ms. Thornton notes that the Commission excluded approximately 500 out of U S WEST's 1,700 central offices from consideration for purposes of stratification and selection without any indication of the criteria employed.³⁴ As a result, Ms. Thornton states, "I cannot determine whether the population is appropriate for the audit objectives or whether the offices selected are likely to be representative of the population of offices."³⁵ She goes on to note that "[i]f it is found necessary to replace randomly selected sample items, for whatever reason, doubts are immediately raised as to the statistical validity of the sampling plan."³⁶ Clearly, the Commission's exclusion of over 500 offices from the "population" raises significant doubts with respect to the validity of the sampling plan even before one looks at sample selection and stratification.

Ms. Thornton also indicates that she has insufficient information to determine whether the stratification used was appropriate. However, she expresses

³⁴ Aug. 18, 1998 Thornton Letter at 2.

³⁵ Id.

³⁶ Id.

concern over the large number of strata (*i.e.*, eleven) and small number of sample selections per strata (*e.g.*, as few as 2 offices per strata). She states “[t]here is insufficient documentation in the Draft Audit Report to justify why so many strata with relatively small sample sizes within a strata might be expected to produce representative results.”³⁷ U S WEST strongly agrees with this observation and seriously questions the “representativeness” of the sample results.

Similarly, Ms. Thornton raises the issue of the audit’s use of random selection of line items when no consideration “is given to using dollar-based selection techniques, rather than simple random selections, to allow appropriate coverage of higher dollar items.”³⁸ She states that “[t]his is particularly relevant in tests of physical existence if high-dollar items are more likely to be located than small-dollar items, due to such factors as physical size and the extent of controls over more valuable assets.”³⁹ There can be no doubt that this is a serious flaw in sample design in an audit that covers items ranging in value from virtually nothing to hundreds of thousands of dollars.⁴⁰ No one would question that it is easier to lose track of a shelf assembly with a value of approximately \$5.00 than a 5ESS side interface valued at \$40,000. However, the audit appears to assume that if

³⁷ Id.

³⁸ Id. at 2-3.

³⁹ Id. at 3.

⁴⁰ The draft audit identified 9 items of less than \$5.00 where the item was “not found” or “unverifiable” by the Commission. Mr. Geppert observes that 449 or 38% of the sample items had a value of less \$2000 and that these items accounted for approximately 3% of the total value of the 1,188 items in the sample. See Geppert Declaration at 10.

U S WEST loses a shelf assembly it is just as likely to lose a 5ESS side interface.

Clearly, this is wrong -- no for-profit business would value such items equally.

U S WEST readily acknowledges that it does not do as good a job at keeping track of \$5.00 items as it does of its digital switches. The reasons are simple -- the costs of such controls far exceed the benefits and it is highly unlikely to have a “material” misstatement of financial records as a result of errors in accounting for items of de minimis value.

The preceding observations deal with sample selection. Of equal importance are Ms. Thornton’s concerns with sample evaluation in the draft audit report. Of particular concern is the size of the precision range associated with the audit’s estimate of hard-wired COE plant which the auditors claim is missing. The audit estimated missing plant to lie between \$181.2 and \$576.0 million based on an estimate of \$378.6 million and precision of \$197.4 million.⁴¹ In pointing out that the total range of uncertainty -- \$394.8 million -- is greater than the draft audit’s estimate of \$378.6 million. Ms. Thornton states:

Typically, I would not expect that an estimate with such a wide precision range would be useful. I would expect that it would be necessary to do additional work, either to improve the precision or to support the use of a particular point within the range. In most instances, an estimate with such large precision would be of little predictive value without the support of independent corroborative information to assist in determining whether any point in the estimated range is reasonable.

⁴¹ Draft Audit at 8.

U S WEST agrees that this issue is of critical importance⁴² -- particularly in light of the fact that no single point in the precision range is any more likely to occur than any other point from a statistical perspective.⁴³ Estimates of the precision contained in the draft audit report are of virtually no use for decision-making purposes in either a business or public service environment.

Lastly, the estimate of missing COE investment in the audit report has an inherent bias in that it only includes “overstatement” errors and did not consider “understatement” errors which were also present in the sample.⁴⁴ Ms. Thornton

⁴² This is the equivalent of saying that the population of the United States is somewhere between 120 million and 380 million people. Interesting -- but not a particularly useful piece of information for decision making purposes.

⁴³ August 18, 1998 Thornton Letter at 3. In making this observation, Ms. Thornton took issue with two other assertions contained in the June draft report. First, she took exception to ASD’s assertion in Footnote 39 (of the June report) that “It is more probable . . . that the actual cost of missing plant lies closer to the mid-point of the range.” She states that “[s]ampling theory does not provide statistical support for [this] assertion.” *Id.* at 4. Ms. Thornton notes in her January 8, 1999 letter that while ASD has removed the offending footnote (Note 39) from its December report it continues to make the same assertion in Footnote 27 and on pages 12-13 of the December report.

Second, she also took exception to the audit report’s claims with respect to the application of the accounting principle of “conservatism” when more specific accounting guidance exists. “In this case, Section C59 of the Financial Accounting Standards Board’s *Current Text* sets forth the accounting for loss contingencies (loss contingencies are defined as existing when “it is probable that an asset has been impaired or a liability had been incurred at the date of the financial statements” [C59.105.a.]). The accounting requirement for loss contingencies, when no amount within a range is a better estimate of the loss than any other amount, states “If no amount within the range is a better estimate than any other amount, however, the minimum amount of the range should be accrued.” (C59.107). ASD resolved this concern by eliminating the reference to the accounting principle of “conservatism” in its December report.

⁴⁴ An understatement error is where the quantity of a line-item on the CPR was less than the quantity actually found.

points out that the audit's estimates "may be higher than they should be, in that they do not allow understatement errors to reduce estimated overstatement."⁴⁵

After reviewing her concerns on the sampling methodology which underlies the audit's attempt to expand its findings beyond the 1,188 items in their sample to the overall universe of hard-wired COE investment, Ms. Thornton states:

In summary, given the several questions and concerns about the sampling approach taken by the FCC, it is possible that the resulting sampling estimates may be invalid (i.e., the range of the estimate does not contain the actual amount of error in the population). Additionally, even if the estimate is in fact valid, the size of the precision range, which is very large in relation to the size of the estimate, creates doubt as to the practicality of using the range for concluding as to the actual amount of error in the population.⁴⁶

As such, U S WEST believes that the Commission should limit the CPR audit to its original purpose -- auditing compliance with the Commission's Part 32 recordkeeping requirements and not attempt to draw conclusions about the level of hard-wired COE investment. As the preceding discussion demonstrates, it is unlikely that the draft audit's estimates of the "overstatement" of COE investment will pass "statistical" scrutiny. Furthermore, even if COE investment is overstated, it is highly improbable that such an event would impact rates.⁴⁷

VII. COST SUPPORT DOCUMENTS CANNOT BE RETRIEVED QUICKLY GIVEN THE EXTRAORDINARY AMOUNT OF MATERIAL WHICH

⁴⁵ Aug. 18, 1998 Thornton Letter at 4.

⁴⁶ Id.

⁴⁷ As Mr. Carl Geppert of Arthur Andersen points out, even "if one were to assume that such audit results were accurate, however, their impact on regulated rates would be minimal" due to the use of Mass Asset Accounting and Remaining Life Depreciation. See Geppert Declaration at 8-9.

MUST BE RETAINED TO SATISFY THE COMMISSION'S PART 32 RULES

As both the July and December draft reports note, ASD auditors requested cost documentation various times on the sample line-items being audited. The first request was on October 20, 1997 when auditors requested complete cost documentation for all 1,188 sample line-items. On January 16, 1998 and in subsequent correspondence, ASD auditors revised their requests downward -- ultimately requesting complete cost documentation on three items.⁴⁸ From the auditor's perspective, U S WEST's responses were incomplete and untimely. However, the amount of work necessary to fulfill the auditors' request for cost documentation was monumental. This work effort was not so much a function of the number of items for which cost support information was requested -- but of the overall volume of COE paper records that had to be searched. In U S WEST's case, personnel had to search through approximately 12,000 boxes of COE records in order to respond to audit requests for cost documentation and to demonstrate the existence of many sample items. While U S WEST was able to document the existence of many items that auditors had classified as "not found," the results were not fully satisfactory in terms of meeting the audit request for "complete" cost documentation as the following table demonstrates for the February 18, 1998 request for cost-support on 50 randomly selected hard-wired COE items.

Sample of '50'	Invoice and Cost Study	Invoice Only	Other	Total
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⁴⁸ Letter from Kenneth M. Ackerman, Chief Audits Branch, Federal Communications Commission, to Michael Crumling, U S WEST, dated May 18, 1998.

Invoice and Cost Study	12			12
Invoice Only		24		24
PICS Reclassification			1	1
No documentation			13	13
Total	12	24	14	50

There are numerous reasons for U S WEST's limited ability to locate the desired records. One of the primary reasons is that with the centralization in recent years of many activities such as engineering, some records were inadvertently destroyed, lost, misplaced or mislabeled. In addition, many of the individuals with responsibility for transferring records were leaving U S WEST as a result of retirements or their decision not to relocate. A point of equal importance is that existing Part 32 CPR recordkeeping requirements (and ASD's interpretation of these requirements) contain a level of detail that is not necessary, economic nor realistic in today's telecommunications environment.⁴⁹ Problems such as those encountered in retrieving the requested documentation which spans decades and which includes multiple relatively small items are not unique to U S WEST or regulated telephone companies. Any organization that is subject to profit or budgetary constraints -- whether they be government or private business face similar difficulties for detailed recordkeeping. One solution to this dilemma is to revamp the CPR recordkeeping requirements in accordance with Arthur Andersen's submission in the Commission's biennial accounting review. As Mr. Geppert observes in his Declaration "the FCC should allow USW and other telecommunications providers subject to the Part 32 Rules and Regulations to

⁴⁹ See Section II, supra.

define and track property units at a level necessary to manage the business, nothing more.”⁵⁰

VIII. U S WEST HAS RESOLVED ISSUES ASSOCIATED WITH ITS UNDETAILED INVESTMENT CATEGORY

The draft audit report indicates that U S WEST had \$218.6 million in Undetailed Investment as of June 30, 1997. The report goes on to state that U S WEST has “failed to substantiate the physical existence of any equipment associated with the Undetailed Investment line-items or provide cost support for the related investment amounts shown in the CPR.”⁵¹ U S WEST regrets the perception reflected in the draft audit report that U S WEST was not responsive to requests from auditors associated with Undetailed Investment. This was not U S WEST’s intent.⁵²

Undetailed Investment is largely a clearing category with amounts continually flowing in and out (*i.e.*, as assigned to specific detailed items). This category is not new and has been in existence since 1968, as indicated by AT&T’s M-295 letter on central office property records.⁵³ Any costs assigned to the Undetailed Investment category should be cleared by the end of the year following the calendar

⁵⁰ Geppert Declaration at 10.

⁵¹ Draft Audit Report at 10.

⁵² Subsequent to the audit staff’s September 9, 1997 request for supporting documents for 200 undetailed items, there were discussions with the staff regarding the onerous nature of their request and the possible use of a sample. These discussions led to the January 16, 1998 request. U S WEST submitted its response to this request on February 18, 1998. Prior to the issuance of the June draft report, there was no indication from the audit staff that U S WEST’s response was in any way inadequate.

year in which the amounts originated. This has not always happened as promptly as it should at U S WEST. However, U S WEST's balance in the Undetailed Investment category stood at \$145.6 million as of August 6, 1998 and U S WEST reported this to ASD in its August 19, 1998 response. This amount represents a significant reduction from the \$218.6 million amount referenced in ASD's December report -- \$218.6 million represented the amount of Undetailed Investment as of December 31, 1996.

Further investigation of U S WEST's August Undetailed Investment balance of \$145.6 million indicated that it was made up of three components: (1) \$14.6 million of investment amounts that will be cleared;⁵⁴ 2) \$106.6 million of unregulated investments and non-COE which is outside the scope of the audit;⁵⁵ and 3) \$24.4 million of investment amounts that are pre-1996 and were not cleared-out in a timely fashion. As of January 7, 1999, U S WEST had cleared all but \$1.7 million from the regulated portion of its Undetailed Investment category.⁵⁶

⁵³ See Attachment 1, Tab J, U S WEST Response, August 19, 1998.

⁵⁴ *I.e.*, by the end of the year following the calendar year in which the costs were incurred.

⁵⁵ The investments associated with unregulated equipment and non-COE were assigned to the Undetailed Investment category because U S WEST intended to use the PICS-DCPR process to track this investment. While unregulated investment was contained in U S WEST's network records (*i.e.*, DCPR), it was never recorded in U S WEST's regulated books of account.

⁵⁶ Of the 25 items for which ASD requested cost support, 21 of the items represented investment prior to the adoption of a mechanized system for tracking this investment category in 1977. All 21 of these items have been retired. See Attachment 3 hereto.

To summarize, U S WEST believes that use of the Undetailed Investment category is appropriate and necessary. No amounts have been inappropriately assigned for regulatory purposes as a result of U S WEST's use of the Undetailed Investment category. As such, there is no basis for ASD's recommendation that U S WEST should write-off \$218.6 million from its COE accounts as unsubstantiated.

IX. U S WEST WILL WORK WITH ASD TO RESOLVE ANY
OUTSTANDING ISSUES WITH THE UNALLOCATED
OTHER COST CATEGORY

ASD's July draft report expressed concern over the "Unallocated Other Costs" category and stated that "this category of costs was discovered during this audit."⁵⁷ Contrary to this statement, "Unallocated Other Costs" is not a new category -- it has been in existence for decades, as indicated by AT&T's M-295 letter.⁵⁸ Typically, unallocated costs are engineering and/or labor costs associated with items which have not yet been reflected on the CPR as well as items such as aisle lighting which will be "loaded" on other items in the CPR. As such, it is impossible to "physically verify" or "locate" many unallocated costs such as engineering and labor costs which cannot "be seen." However, these costs will be associated with physical items once they are spread to specific CPR items.

The use of the "Unallocated Cost Category" is proper and necessary to the CPR process. As with any other clearing category, costs move in and out of the "Unallocated Other Costs" category. The balance in this account was \$102 million

⁵⁷ Draft Audit Report at 11.

as of the end of July 1998. This is a reduction of \$20 million from the \$122 million that was contained in the July draft report. The current balance of \$102 million in Unallocated Costs is made up of three components: 1) \$21.2 million of costs that will be allocated in the normal course of business; 2) \$20.5 million unregulated and non-COE costs which are beyond the scope of this audit; and 3) \$60.3 million of pre-1996 costs which will be respread to other CPR items or retired if no related depreciable hard-wire material costs exist.

In summary, the Unallocated Other Costs is a clearing category that has been in existence for decades. U S WEST and all other former Bell System Companies have employed this category to track and assign those capital costs that relate to more than one item on the CPR. U S WEST will work with ASD auditors to address any outstanding concerns that they may have with this category.

X. ASD'S RECOMMENDATIONS IGNORE U S WEST EVIDENCE
AND ARE BASED ON HIGHLY QUESTIONABLE STATISTICAL
INFERENCES

ASD's December audit report concludes with three recommendations:

- That U S WEST should write off \$597.2 million from its COE accounts to remove \$378.6 million of hard-wired COE plus \$218.6 million of Undetailed Investment.⁵⁹
- That U S WEST should be required to engage an independent auditor to perform an inventory of its entire COE.⁶⁰
- That U S WEST should be required to engage an independent auditor to review its practices, procedures, and controls for maintaining CPR.⁶¹

⁵⁸ See Attachment 1, Tab J, U S WEST Response, August 19, 1998.

⁵⁹ Report at 16.

⁶⁰ Id.

The Commission should dismiss ASD's first recommendation as unsupported speculation. As discussed above, there is no statistically valid basis to conclude that U S WEST's hard-wired COE is overstated by \$378.6 million, nor that the amount of Undetailed Investment is anywhere close to \$218.6 million (*i.e.*, as of January 7, 1999, the value of this category was \$1.7 million). Mr. Geppert of Arthur Andersen finds ASD's recommendation that U S WEST write-off of \$378.6 million of hard-wired COE to be "fundamentally flawed."⁶² He also finds ASD's recommendation to write-down \$218.6 million of Undetailed Investment to be inappropriate since ASD has not taken steps to verify U S WEST's Undetailed Investment balance, nor has it modified its audit results.⁶³

As to ASD's second recommendation -- to conduct a complete COE inventory - it is, at best, premature. Such an inventory would be a vast and costly undertaking. It makes no sense to conduct such a complete inventory until an evaluation of U S WEST's existing practices, procedures, and controls for maintaining CPR is completed.. As Mr. Geppert observes, "[f]urther substantive audit procedures, such as the performance of a complete physical verification of all COE as recommended by the ASD, should not be performed until the procedures and controls review [of CPR] as discussed above is completed."⁶⁴ Even if the

⁶¹ Id.

⁶² Geppert Declaration at 7.

⁶³ Id.

⁶⁴ Id. at 8.

Commission determines that physical verification is necessary, any such inventory should focus on high dollar value items.⁶⁵

ASD's third recommendation -- that U S WEST's CPR procedures and controls be reviewed by an independent auditor -- is not without merit. However, any such review should precede any action on any of ASD's other recommendations. U S WEST would not object to such a review as long as it is conducted by an independent auditor and the review focuses on both U S WEST's compliance with existing Commission CPR recordkeeping rules and the costs/burdens associated with complying with current rules. Not only would such a review assist U S WEST in refining its processes, but it would also provide the Commission with information as to how its rules might be simplified to enhance compliance and eliminate rules that are no longer useful or relevant.

XI. CONCLUSION

As the foregoing demonstrates, U S WEST has largely "found" most of the items that ASD auditors previously classified as "not found" or "partially found." Despite these corrections, U S WEST remains of the opinion that it would be inappropriate to extrapolate the results of this audit to estimate over- or understatements in hard-wired COE investment given concerns raised with regard to ASD's sampling methodology. Furthermore, there is no basis at the present time for the Commission to even consider ASD's recommendations with respect to writing-down almost \$600 million of U S WEST's COE investment or requiring

⁶⁵ Id.

U S WEST to engage an independent auditor to perform an inventory of its entire COE. U S WEST does not object to ASD's third recommendation -- that U S WEST engage an independent auditor to review its practices, procedures, and controls for maintaining CPR and plant balances in compliance with the Commission's rules -- if the Commission determines that such a review is necessary.

Respectfully submitted,

U S WEST, INC.

By:

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Its Attorney

January 11, 1999

ATTACHMENT 1

ATTACHMENT 2

ATTACHMENT 3

CERTIFICATE OF SERVICE

I, Rebecca Ward, do hereby certify that on this 11th day of January, 1999, I have caused a hard copy of **U S WEST, INC.'S RESPONSE TO DRAFT AUDIT FINDINGS - AUDIT OF CONTINUING PROPERTY RECORDS** (along with an electronic copy on diskette) to be submitted, via hand delivery, to the person listed below:

**Robert Hood
Federal Communications Commission
Accounting Safeguards Division
Room 257
2000 L Street, N.W.
Washington, DC 20036**

Rebecca Ward